# THE IMPACT OF ECONOMIC GROWTH ON THE TRADE BALANCE OF WESTERN BALKAN COUNTRIES

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Abstract: The aim of this paper is to examine the impact of Gross Domestic Product (GDP) growth on the merchandise trade balance (MTB) in Western Balkan countries (Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia). In general, an increase in domestic production leads to higher employment, which in turn raises disposable income for purchasing both domestic and foreign products. The rise in import activities, coupled with limited export capacities, results in an MTB deficit and, consequently, a current account deficit in these countries, *negatively affecting external (balance of payments)* equilibrium. The relationship between GDP and MTB is analyzed using the Pooled Mean Group (PMG) model over the period 2014Q1-2024Q3. The research findings indicate a statistically significant long-term negative relationship between GDP and MTB for all observed economies, confirming that GDP growth deepens the MTB deficit. In the short run, the relationship between the examined variables is also negative, but with heterogeneity across countries. A statistically significant short-term negative impact is identified in Bosnia and Herzegovina, Montenegro, and Serbia, while in Albania and North Macedonia, the short-term relationship is not statistically significant. To mitigate the chronic MTB imbalance, economic policymakers in the Western Balkans should focus on strengthening the competitiveness of national economies through technological advancements and innovation,

fostering domestic production, expanding export capacities, and ultimately reducing import dependency

Key words: Gross Domestic Product, Merchandise Trade Balance, Western Balkan, PMG model

JEL classification: E66, F41, F43

#### 1. INTRODUCTION

Balancing between the goals of internal equilibrium (stable and low inflation rate, sustainable economic growth, low unemployment rate) and external (balance of payments) equilibrium in terms of the absence of chronic deficits/surpluses in the balance of payments is a complex task for economic policymakers. Accelerated economic growth in the context of gross domestic product (GDP) growth can have significant implications for trends within the merchandise trade balance (MTB). In general, GDP growth leads to higher income and consumption, stimulating import demand. However, if export activities do not grow at the same pace, the MTB deficit becomes chronic, potentially jeopardizing external equilibrium. On the path of real convergence, the Western Balkan countries exhibit a continuous MTB deficit. In this regard, analyzing the relationship between GDP and MTB can contribute to a better understanding of the factors shaping external equilibrium and the

long-term economic sustainability of these economies.

This study is conducted within non-stationary, heterogeneous panels using the Pooled Mean Group (PMG) model, examining the long-term and short-term relationship between GDP and MTB for five Western Balkan countries: Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia over the period 2014Q1–2024Q3. The aim of the research is to assess how GDP growth affects MTB while considering the specificities of individual economies.

Accordingly, the hypothesis tested in this paper is: (H1): There is a negative long-term and short-term relationship between GDP and MTB in the Western Balkan countries, with heterogeneous adjustments in relation to the long-term equilibrium over the period 2014Q1–2024Q3.

The remainder of the paper is structured as follows: after the introduction, a literature review presents different perspectives in the economic literature regarding the interdependence between GDP and MTB. The third section provides a descriptive statistical analysis, followed by the presentation of empirical research results. Finally, the fifth section offers concluding remarks.

## 2. LITERATURE REVIEW

Responsible, efficient and sustainable economic policy management entails creating conditions for achieving macroeconomic stability and economic growth through increased investment, exports, and savings. productivity, competitiveness (Marjanović Beraha and Simović, 2021). The economic growth and development of Western Balkan countries are significantly influenced by the integration of national economies into international economic flows (Jovičić and Stojanović, 2022). More intensive integration with developed European economies provides developing countries with an opportunity to achieve higher growth rates than countries in other regions with similar income levels. In this way, the process of real convergence is achieved. Economies that are strongly involved in the process of globalization can experience higher investment inflows, greater trade exchange, and higher growth rates. Globalization enhances capital flows, productivity, and citizens' living standards (Dimitrijević, 2016).

However, rapid economic growth is often accompanied by external imbalances, particularly in the form of current account deficits (Ercegovac and Beker Pucar, 2022). In the case of Western Balkan countries, the current account deficit largely stems from a growing foreign trade imbalance, with a chronic MTB deficit as imports significantly exceed exports (Sekiraca and

Gazmend, 2020). The MTB deficit, and consequently the current account deficit, does not necessarily pose an urgent problem if there are adequate financing mechanisms. One desirable outcome is covering the deficit with long-term capital in the form of foreign direct investment (FDI). FDI serves as a crucial source of capital in less developed economies with insufficient domestic savings. Given the substantial FDI inflows in most Western Balkan countries, these inflows can be a source of long-term economic growth, provided that the funds are utilized appropriately (Marjanović, et al., 2021). The interest of every export-oriented economy is to attract FDI into new production capacities to eliminate trade deficits and establish external balance. FDI facilitates the adoption of new technologies and access to global markets, positively impacting real convergence. The efficient use of this type of external capital can lead to increased production, employment, exports, and living standards (Popescu, 2014; Ejupi Ibrahimi and Fetai, 2022). The more open an economy is, the greater the positive impact of FDI on employment, regardless of whether the country is developing or developed (Shengelia, Kozak and Kirkitadze, 2020). The potential benefits of FDI largely depend on the quality of national infrastructure, market size, institutional strength, education system, and political stability (Estrin and Uvalić, 2016). Some countries can sustain deficits if they have a skilled workforce and high GDP per capita, allowing consumers to repay debts accumulated through consumption. Conversely, a prolonged and inadequately financed deficit can lead to severe economic problems and crises.

There are different perspectives in the economic literature on the relationship between economic growth and foreign trade. One group of authors supports the export-led growth theory, which posits that export growth is the key driver of longterm economic growth (Cetintaş and Barişik, 2009; Nguyen, 2011; Gurgul and Lach, 2014; Busse and Königer, 2015; Tahir and Azid, 2015; Bakari and Mabrouki, 2017; Huchet-Bourdon, Le Mouël and Vijil, 2017; Marjanović and Domazet, 2021). Another group of authors argues that economic growth influences exports (Kaldor and James, 1962; Shan and Tian, 1998; Lovrinčević and Mikulić, 2000; Chang, 2011; Thirlwall, 2011). International trade is considered a dominant factor in economic growth, especially for small and open economies (Ali, Fatima and Basel, 2023). Every country aims to increase production and exports to achieve stable economic growth. Given that accelerating real convergence and catching up with developed economies involve income growth, consumption and imports, sustainable long-term growth can positively affect export capacity and trade balance improvement. Furthermore, stable and strong economic growth enhances export competitiveness, potentially reversing the relationship between the real economy and external imbalances (Erjavec and Bogdan, 2017). The MTB deficit, as the primary trigger of current account imbalances, is partly driven by GDP growth and closer integration with developed European economies (Sekulić, Beker Pucar and Glavaški, 2024).

Economic growth generally boosts income, leading to higher demand, consumption and imports. This trend is particularly evident in countries with high import demand and limited export capacity, such as the Western Balkans. Using the identity GDP = C + I + G + (X - M), where GDP represents total production, C - private consumption, I - investment, G - government spending, X - exports, and M - imports, it follows that exports increase GDP while imports reduce it. However, the import of capital equipment, investment machinery and new technology, despite generating short-term deficits, can foster long-term growth production, productivity, in competitiveness and ultimately, exports, thereby driving GDP growth. When countries are exportoriented, have a diversified export structure and a significant share of highly processed export goods, positive externalities can extend to non-export sectors. As Ibrahim (2002) emphasizes, export growth in GDP cannot be achieved without increasing imports of new equipment and technology, as well as raising capital expenditure

participation in GDP. An export-led growth strategy is particularly important for developing countries (Hakobyan, 2011). Eberhard-Ruiz and export Calabrese (2018)highlight that competitiveness is essential for successful participation in the global economy and for reducing trade deficits. Additionally, export structure diversification is crucial as it enhances economic resilience to external shocks, facilitates the integration of small and medium-sized enterprises and promotes innovation (Songwe, 2019).

# **3. DESCRIPTIVE ANALYSIS**

In the Western Balkan countries, a persistent MTB deficit is evident, with its intensity varying depending on economic structure, trade policy and global economic shocks (Figure 1). In Albania, during the analyzed period 2014Q1-2024Q3, the deficit gradually increased from 600 million to 1.5 billion euros, worsening during the pandemic and geopolitical crises. A similar trend is observed in Bosnia and Herzegovina, with fluctuations during global crisis episodes. In Montenegro and North Macedonia, MTB deficits are lower in absolute terms, displaying a more stable trend throughout the period. Serbia exhibits the most pronounced fluctuations among the observed countries, with a record-high deficit in 2022, indicating significant import dependency and the negative impact of geopolitical developments and the energy crisis.



Source: Authors according to IMF

Analyzing the MTB deficit relative to GDP provides a more relevant perspective and assessment of economic sustainability. As shown in Figure 2, Montenegro has the highest MTB deficit relative to GDP, with values averaging between 40% and just under 70% over the observed period. These percentages highlight Montenegro's exceptional dependence on imports, given its economic structure, in which tourism and import-oriented consumption play a dominant role. As a result, the most significant fluctuations occur in the summer quarters, reflecting the seasonal nature of this balance. Albania and Bosnia and Herzegovina exhibit similar trends; however, their fluctuations have been more pronounced due to escalating geopolitical tensions. In the case of North Macedonia, the deficit as a percentage of GDP is somewhat lower but has also worsened following the outbreak of the Ukraine conflict. In Serbia, the MTB deficit remains lower than in the other economies of the region.

Figure 2: MTB deficit (% of GDP)



Source: Authors according to WB

It is relevant to compare GDP (Figure 3), GDP per capita (Figure 4) and GDP growth rates (Figure 5) for the Western Balkan countries. GDP is a crucial indicator of a country's economic activity and development. All Western Balkan economies have recorded GDP growth, with the most pronounced increase in Serbia, where GDP reaches up to 20 billion euros in certain quarters. This can be attributed to higher production levels as well as inflationary trends. Other countries demonstrate a gradual but stable upward trajectory. These trends indicate positive growth, but they also reflect structural differences among the countries that influence the dynamics of their economic development.



Figure 3: GDP in the Western Balkan countries

Source: Authors according to Eurostat

GDP per capita is a good indicator of economic growth. Overall, the Western Balkan countries show a trend of real convergence, with some divergence when it comes to GDP per capita. The highest GDP per capita is recorded in Montenegro, for several reasons. First, Montenegro heavily relies on tourism, which makes up a significant portion of its GDP. The country sees a large number of foreign tourists every year, and tourism is a highly profitable industry that positively impacts economic growth. Additionally, the population is smaller, and so on. Serbia positions itself right behind Montenegro, with stable and accelerated growth, particularly after 2020, when it catches up to and slightly surpasses the GDP per capita achieved in Montenegro. In the other countries, GDP per capita is at a somewhat lower level, with a growth trend during the observed period.



Figure 4: GDP per capita

Source: Authors according to Eurostat

The trends observed in GDP growth rates indicate relative stability and uniformity across all countries until 2020, a sharp decline due to the COVID-19 pandemic, and a strong recovery afterward. The steepest decline in economic activity, as well as the most significant postpandemic growth, was recorded in Montenegro. Other countries also experienced negative growth rates during the pandemic, but with less intensity.

Figure 5: GDP growth rates (%)



Source: Authors according to WB

The analysis of the MTB deficit and GDP growth in Western Balkan countries highlights persistent structural challenges, with the intensity of the deficit varying depending on developments in the international environment, global economic shocks, and the economic structure of individual economies.

## 4. ANALYSIS OF RESULTS: PMG MODEL

This analysis is based on an econometric panel data framework, which allows for examining the long-term and short-term relationship between gross domestic product (GDP) and the merchandise trade balance (MTB) in Western Balkan countries. The objective is to assess their interdependence over the past ten years. The sample includes data for five countries (N=5) over the period 2014Q1-2024Q3 (T=43). In this study, macro panel methods were applied to test hypothesis H1 using the PMG model. The dependent variable (MTB) and the independent variable (GDP) are expressed in millions of euros. Thus, our specification is as follows:

$$\Delta MTB_{it} = \phi_i(MTB_{it-1} - \theta_i GDP_{it}) + \sum_{j=1}^{p-1} \lambda_{ij} \Delta MTB_{it-1} + \sum_{j=0}^{q-1} \delta_{ij} \Delta GDP_{it-j} + \mu_i + u_{it}$$

where MTB<sub>it</sub> presents dependent variable while the cross-section units are represented by i = 1, 2, ...,N; the number of periods t = 1, 2, ..., T; GDP<sub>*it*</sub> is a k  $\times$  1 vector of explanatory variables;  $\phi_i$  is the errorcorrection parameter, which presents adjustment mechanism toward long-run equilibrium relationship for each which presents an adjustment mechanism toward the long-run equilibrium relationship for each Western Balkan country. The error-correction parameter is expected to be negative under the assumption that long-run relationship exists and variables converge to longrun equilibrium; in contrast,  $\phi_i = 0$  means that there is no long-run equilibrium;  $\theta_i$  is the long-run equilibrium relationship between variables;  $\lambda_{ij}$  is the coefficient of the lagged dependent variable,  $\delta_{ii}$ is the short-run coefficient for each panel unit (WB country);  $\mu_i$  represents the individual effects and  $\mu_{it}$ is the stochastic disturbance term. First, crosssectional dependence (CSD) of the data was tested. Table 1 presents the results of Pesaran's CSD test. The findings indicate that the null hypothesis (H0) of independence must be rejected, confirming that the observed variables are dependent. This outcome is expected, as GDP growth implies an increase in income and, consequently, imports, leading to a deficit in the MTB.

Sample: WB countries; period 2014Q1-2024Q3				
Variables	Pesaran CD test	p-value		
MTB	13.99	0.000		
GDP	19.16	0.000		

Source: authors' own calculations.

The results of the CSD test necessitate the use of second-generation unit root tests. The unit root tests suggest that the null hypothesis (H0) of non-stationarity cannot be rejected, indicating that both

Table 2. Pesaran CIPS test

was confirmed that they are stationary (Table 2).

variables are non-stationary. Subsequently, the

stationarity of the first differences was tested and it

Sample: WB countries; period 2014Q1-2024Q3					
Variab les	L a g s	PURT test in the Level	p- value	PURT test at the first diffs.	p- value
	0	-3.506	0.000	-6.112	0.000
МТВ	1	-3.375	0.000	-6.190	0.000
	2	-1.426	0.008	-5.510	0.000
	0	-4.364	0.000	-5.973	0.000
GDP	1	-3.629	0.000	-5.450	0.000
	2	-1.685	0.589	-5.088	0.000

**Source:** authors' own calculations.

The Westerlund test was used to examine cointegration, indicating that the null hypothesis (H0) of no cointegration is rejected and that the alternative hypothesis of the existence of cointegration between these variables is accepted (Table 3).

 Table 3: Westerlund cointegration test

Sample: WB countries; period 2014Q1-2024Q3		
Westerlund cointegration test	p-value	
-2.2985	0.0108	

Source: authors' own calculations.

Table 4 presents the homogeneous coefficients obtained using the (P)MG model. The findings indicate a negative and statistically significant long-term relationship between GDP growth and MTB (-0.2232 for MG and -0.2115 for PMG, respectively) in the period 2014Q1-2024Q3.

This implies that in the long run, a 1 unit increase (millions of EUR) in GDP leads to a 0.23 (MG) and 0.21 (PMG) unit increase (millions of EUR) in the MTB deficit. In the short run, a 1 unit increase in GDP (millions of EUR) worsens the MTB by 0.10 (MG) and 0.14 (PMG) units (millions of EUR), respectively).

The equilibrium error correction parameter is significant and negative, indicating the speed of adjustment toward long-term equilibrium.

It is observed that each quarter, 59.5% and 43.3% of the trade balance dynamics adjust toward equilibrium.

The Hausman test serves as the basis for choosing between the MG and PMG models. If the null hypothesis (H0) of parameter homogeneity cannot be rejected, the PMG estimator is more efficient.

Conversely, if the alternative hypothesis is accepted, the MG estimator is more efficient (p-value < 0.05). In our study, the p-value is 0.7918, based on which we select the PMG model for further analysis.

Sample: WB countries; period 2014Q1-2024Q3				
Dependent variable: MTB				
	MG		PMG	
Long-run Equilibrium ( $\theta$ )	Coef.	p-value	Coef.	p-value
	-0.2232	0.000	-0.2115	0.000
Short-run relationship	Coef.	p-value	Coef.	p-value
	-0.1011	0.073	-0.1443	0.005
Error-Correction (Φi)	Coef.	p-value	Coef.	p-value
	-0.5951	0.000	-0.4328	0.000
Hausman test statistic			0.7918	

Table 4: PMG and MG estimator results

**Source:** authors' own calculations.

The main advantage of heterogeneous panels is that they allow for the evaluation of each economy in the context of the error correction parameters. The error correction, which reflects the adjustment toward long-term equilibrium, is statistically significant and negative in all observed Western Balkan countries.

Albania exhibits the fastest adjustment (80.4%), followed by Montenegro (49.3%), North Macedonia (39.1%), Bosnia and Herzegovina (27.4%), and finally Serbia (20.2%) (Table 5).

The fastest adjustment of the Albanian economy to long-term equilibrium can be explained, among other factors, by the fact that the Central Bank of Albania applies a free-floating exchange rate regime, which typically functions as an absorber of external shocks (Bank of Albania, 2025). Conversely, Bosnia and Herzegovina, Montenegro, and North Macedonia apply rigid exchange rate regimes, meaning that their monetary policy loses sovereignty and is subordinated to defending the parity.

Regarding Serbia, the Central Bank of Serbia implements a managed float exchange rate regime, which has been de facto stable since 2017 and, as such, is not functioning as an absorber of shocks or as a stimulant for export competitiveness (Beker Pucar, 2020).

The coefficients in the short run are also negative but divergent between countries.

The statistically significant short-term impact is present in Bosnia and Herzegovina, Montenegro, and Serbia, indicating that GDP growth coincides with the worsening of the MTB deficit in the short run, while this is not the case in Albania and North Macedonia.

Sample: WB countries; period 2014Q1-2024Q3				
Dependent variable: MTB				
PMG Estimator	Error-correction		ΔGDP	
Estimator	(+1)			-
WB countries	Coef.	p- value	Coef.	p- value
Albania	-0.8044	0.000	-0.0183	0.757
BiH	-0.2737	0.003	-0.3078	0.000
Montenegro	-0.4935	0.000	-0.1985	0.000
North Macedonia	-0.3906	0.001	-0.0526	0.348
Serbia	-0.2020	0.038	-0.162	0.015

Table 5: PMG estimator results

**Source:** authors' own calculations.

### CONCLUSION

The Western Balkan countries face significant challenges regarding the coordination of internal and external balance objectives. The long-term merchandise trade deficit in these countries is caused by the limited competitiveness of domestic production on the international market, restricted export capacities, and high import dependence. Therefore, carefully designed economic policy measures are of utmost importance to ensure sustainable external balance while stimulating economic growth.

The research results indicate the existence of a statistically significant negative long-term relationship between GDP growth and the merchandise trade deficit in all five observed Western Balkan countries from 2014Q1-2024Q3, with Albania showing the fastest adjustment to long-term equilibrium, followed by Montenegro, North Macedonia, Bosnia and Herzegovina and finally Serbia. In the long run, GDP growth is increased accompanied by income and consumption, but the additional demand for goods is satisfied by imports, which negatively affects the trade balance.

In the short run, a negative relationship between GDP and the merchandise trade balance was also observed, but it is heterogeneous among the observed countries. Specifically, a statistically significant negative short-term effect was observed in Bosnia and Herzegovina, Montenegro and Serbia, while in Albania and North Macedonia, this relationship was not confirmed as statistically significant. These results suggest that, in certain economies, it is possible to achieve GDP growth without an immediate deterioration in the merchandise trade balance, but in the long run, the effects remain negative.

One of the key directions for the economic policies of these countries is to encourage innovation and technological advancement in national industries. Increasing production capacity through investments in research and development, digitalization, and modernization of production processes can contribute to greater competitiveness of domestic products on the international market and reduce import dependence.

Also, the diversification of the export structure, focusing on products with higher added value, is essential for improving foreign trade merchandise exchange. Attracting foreign direct investments, particularly in sectors that enable the transfer of knowledge and technology, can play a crucial role in strengthening domestic production. Creating a stimulating business environment through tax incentives, more efficient administration, and legal certainty can attract investors who would contribute to the development of more competitive and technologically advanced industries.

Sustainable GDP growth is possible if accompanied by structural reforms that will increase export potential and reduce import dependence. Otherwise, the merchandise trade deficit may become a permanent issue, which could negatively affect macroeconomic stability and the long-term economic sustainability of the region.

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